

Buying or selling real estate in 2007? Tax withholding — with a twist

It's true — a buyer of real estate in California may be responsible for the payment of a seller's unpaid income tax liability resulting from the sale of the property.

Real estate withholding is a payment to the State of California by the seller to prepay a potential income tax liability. When required, payment is usually made from the seller's funds at the closing of their sale of California real estate.

If the seller was not exempt and did not pay the required withholding amount, the buyer may be liable for the payment of the amount that should have been paid by the seller, plus interest and a penalty in the amount of \$500 or 10 percent of the amount required to be withheld, whichever is greater. There are some exceptions; those with specific questions on this topic should consult their legal advisor. To avoid this unhappy circumstance, buyers should confirm prior to the closing of their escrow that the necessary withholding forms have been completed by the seller and that instructions have been given for payment if required. Buyers are entitled to a copy of the withholding exemption or withholding payment form for their records.

California withholding is not a payment of federal income taxes nor is it a separate or additional tax on the sale of real estate; it is

Guest column



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similar to other withholding designed to ensure a "pay as you go" form of tax payment.

Sellers determine their exemption from or liability for withholding by completing a Franchise Tax Board form, signed under penalty of perjury, and returning the form to their escrow holder before closing.

Exemptions from withholding

Property qualifies for an automatic exclusion and withholding is not required if the total sales price is less than \$100,000 if the transfer is due to a foreclosure, or if the seller is a bank acting as a trustee.

Exemptions for individuals exist primarily for individual sellers who can certify that the property was their primary residence, or are exempt due to other circumstances including participation in a tax-deferred exchange.

Other exemptions exist for sellers who qualify for different treatment as defined in Internal Revenue Code, for those sellers with a loss or zero gain in the property, or where the seller is a California corporation or other qualified, non-individual entity. A complete list of exemptions

appears on the actual tax form.

Payment of withholding

In the past, nonexempt sellers paid withholding at closing at a standard rate of 3 1/3 percent of the sales price. For example, on a \$500,000 sales price, a seller would pay withholding to the State of \$16,650. The most significant change for transactions closing in 2007 is the passage of AB 2962, which allows nonexempt sellers to choose withholding at either the standard rate or at a different amount based on their estimated taxable gain on the property. When based on gain, sellers can elect to pay an alternative tax withholding amount, calculated as a percentage of gain rather than sales price, as follows: 9.3 percent for individuals, 8.84 percent for corporations, 10.84 percent for banks/financial corporations, 1.5 percent for S corporations and 3.5 percent for financial S corporations. Therefore, the individual seller with a gain of \$100,000 on the same \$500,000 sale could pay only \$9,300 at closing.

Alternative withholding allows a seller with minimal gain to pay withholding at an amount representative of their anticipated year-end tax liability. Conversely, the seller with significant gain who elects alternative withholding may find their payment is greater than that based

on the sales price; it remains the seller's option to determine on which basis the tax should be paid. However, a nonexempt seller who does not specifically elect alternative withholding is subject to withholding at the standard rate.

While real estate and escrow professionals should be aware of the recent changes and their impact on closings in 2007, AB 2962 further provides that "Title and escrow persons and exchange accommodators are not authorized to provide legal or accounting advice for purposes of determining withholding amounts. Transferors are strongly encouraged to consult with a competent tax professional for this purpose."

Buyers and sellers can obtain more information on real estate withholding, including an online worksheet to assist with the calculation of gain, at the Franchise Tax Board's Web site at http://www.ftb.ca.gov/forms/07_forms/index.html.

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